

The Treatment of the Subordinated Debt in *Tribune Media* is not of Subordinate Interest

As readers of this column know, your editors have been closely following the appeal from the Tax Court's decision in *Tribune Media*, the case that addressed the tax treatment of the transaction whereby the Tribune Company (Tribune) effectively transferred control of the Chicago Cubs to the Ricketts family.¹ The transaction was a "leveraged partnership" in which Tribune transferred the Cubs to a partnership with Ricketts Acquisition, LLC (RAC) and the partnership incurred two tranches of debt, senior debt of approximately \$425 million and subordinated debt of approximately \$250 million. The debt proceeds were distributed by the partnership to Tribune, which had guaranteed the loans, and the parties took the position that the distribution did not result in a disguised sale under Section 707(a)(2)(B) and Reg. 1.707-5 because the debt-financed proceeds were distributed to the partner (Tribune) that bore the economic risk of loss with respect to the related debt.

Most of the attention given to this case has focused on the senior debt, where the Tax Court upheld the tax planning and concluded that the distribution was not taxable as part of a disguised sale. However, the Tax Court issued a split decision when it addressed this transaction, concluding that the subordinated debt should not be treated as debt for tax purposes, so that the distribution of the proceeds from the subordinated debt could not be a debt-financed distribution (and, hence, was part of a disguised sale taxable to Tribune). The government appealed its loss with respect to the tax treatment of the senior debt, prompting the taxpayer to cross appeal the issue that it lost, i.e., whether the subordinated debt should be treated as debt for tax purposes.

This Shop Talk will focus on the taxpayer's recently filed brief with respect to the tax treatment of the subordinated debt, which was held by Ricketts Education Trust Finance, LLC (Ricketts Finance). When the transaction was put together, the partnership that held the Cubs (Chicago Baseball Holdings, LLC, or CBH) attempted to issue the subordinated debt to third-party investors. However, the transaction was undertaken during the financial crisis of 2008-09, and CBH was unable to find any takers for the subordinated debt.

Ultimately, in order to complete the transaction, Ricketts Finance acquired the subordinated debt from CBH.

The subordinated debt was not "vanilla" debt because it had certain atypical features. Specifically, the holder of the subordinated debt received parking for Cubs games, a luxury box, playoff ticket options and other baseball-related privileges. On the other hand, the subordinated debt had all of the usual hallmarks of debt, including provisions concerning the impact of a default, customary remedies and a typical subordination agreement with the senior debt. Finally, and most importantly from the Tax Court's point of view, the subordinated debt was held by Ricketts Finance, which meant that the subordinated debt was held by a person related to one of the partners in CBH.

The taxpayer's brief disputed the treatment of the subordinated debt as equity for tax purposes. Although the Tax Court had applied the long-established 13 *Dixie Dairies* factors² in reaching its conclusion that the subordinated debt should be viewed as equity for tax purposes, in its brief on appeal, the government advanced three arguments in addition to pointing to the multi-factor analysis. First, the government contended that the subordinated debt had to be treated as equity for tax purposes because a related party held the subordinated debt and would not have enforced it in the event of a default. Second, the government contended that because the subordinated debt was (surprise!) subordinated to the senior debt, it must be viewed as equity for tax purposes. Third, the government argued that even if the parties intended that the subordinated debt should be viewed as debt for tax purposes, that treatment should be disallowed because debt treatment was intended to obtain a tax benefit.

The taxpayer's primary position in its appeal on this issue is that the proper tax treatment of the subordinated debt depends upon the parties' intent, which was to create debt (and not equity). The taxpayer pointed out that all parties to the transaction consistently and unambiguously treated the subordinated debt as real debt from an economic perspective. The loan documents provided for a fixed loan amount with a fixed rate of interest, a fixed repayment schedule for principal and interest, and remedies in the event of a default. The subordinated debt was treated as debt in the parties' financial statements as well as in their submissions to Major League Baseball (MLB), which had to approve the transaction, and to the rating agencies. It remained consistently treated by the parties as debt when, years later, the Ricketts family acquired the remaining portion of CBH that had been retained by Tribune in the original transaction.

Interestingly, although the senior lenders treated the subordinated debt as debt (and required a subordination agreement for that reason), the government contended that state law treatment does not determine the federal tax treatment of the subordinated debt. The taxpayers disputed this contention, stating that the treatment of the debt for state law purposes is an important factor in determining the tax treatment of such debt. The taxpayers also emphasized that the ratings agencies, MLB and even a bankruptcy court (because Tribune was in bankruptcy) treated the subordinated debt as debt, and so it should have the same treatment for tax purposes.

The taxpayer also focused on the Tax Court's conclusion that the parties did not intend for the subordinated debt to be treated as debt from an economic perspective. Amongst other points, the Tax Court had relied on the prospectus that was prepared when CBH tried (unsuccessfully) to offer the

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subordinated debt to unrelated third parties. In particular, the Tax Court had emphasized that the subordinated debt came with certain privileges that are typically afforded to team owners. The taxpayer countered that those privileges (such as watching games from a skybox, holding events at the ballpark, preferred parking, etc.) were also available to persons who are not owners of the team, so they did not indicate ownership of the team. The taxpayer also argued that the fact that the holder of the subordinated debt had a right of first refusal with respect to any future sale of the Cubs demonstrated that the subordinated debt itself was not equity.

Finally, the taxpayer faced off against the government's primary argument, which is that the relationship between CBH and Ricketts Finance meant that the subordinated debt should be treated as equity for tax purposes. The taxpayers asserted that (1) CBH and Ricketts Finance were separate legal entities that were owned by different people, with different business purposes and different legal rights and obligations, (2) the court may not disregard separate legal entities for tax purposes when each entity has a separate business purpose,³ and (3) it is routinely accepted for taxpayers to issue debt to a related party, and the relationship between the debtor and the creditor does not automatically result in treating such debt as equity for tax purposes. The taxpayer conceded that Marlene Ricketts, the holder of the subordinated debt, had not negotiated its terms, but noted that the Tax Court had not relied on this fact. Moreover, according to the taxpayer, the potential for more-favorable terms than would have been received by a third party did not convert the subordinated debt into equity. The taxpayer's primary point was that the government seemed to be positing that any loan between related parties could not be respected as debt for tax purposes—which, is clearly not the law.

The government additionally maintained that the mere fact that the subordinated debt would be paid after the senior debt caused it to be treated as equity for tax purposes, which is an argument that also reaches too far. Subordinated debt is common, and although subordinate, still debt. The taxpayer highlighted that the claims of the subordinated debtholders would have been on an equal footing with CBH's other, unrelated-party obligations in the event of a bankruptcy (and superior to any equity holders).

The government further emphasized that the subordinated debt was structured as debt because there were tax benefits as a result. The taxpayers responded that this argument was self-defeating, because it showed that the taxpayers intended for the subordinated debt to be treated as debt—otherwise, they would not have obtained their intended tax benefits.

The taxpayers addressed the thirteen factors on which the Tax Court relied in treating the subordinated debt as equity. The taxpayers pointed out that the Tax Court improperly ignored the fixed maturity date of the subordinated debt on the basis that it could not be repaid while the senior debt was still outstanding, but this limitation usually applies to subordinated debt. More importantly, the taxpayers countered the government's assertion that interest on the subordinated debt could only be repaid from earnings, pointing out that (1) unpaid interest was added to principal, which could be repaid from any source, and (2) 70% of the interest on the subordinated debt had been paid currently. The taxpayer emphasized that CBH was adequately capitalized, although the Tax Court had reached a different conclusion because RAC Finance had not been able to issue the subordinated debt to a third party.

The oral argument in the Seventh Circuit Court of Appeals recently took place on February 15, 2024. Shop Talk urges our readers to listen to the recording, which is only 30 minutes long and highly enlightening. In the oral argument, after a back-and-forth discussion about whether the subordinate debt question was a decision of fact or law, or both – including a riposte in which the court refused to refer to the 13 factors as a "test" and instead called it a "list" – the implication of subordination was the first purported legal error that the taxpayer highlighted in its cross appeal. The taxpayer emphasized that mere subordination is not dispositive of equity treatment under the law:

"It can be a relevant fact [that the] debt is subordinated, if the effect of subordination is that it is paid on par with equity. But if it's still paid on par with, for example, the general unsecured debt, which is what happened in this case, then it's debt."

The taxpayer then argued that the Tax Court erroneously assumed that related

parties cannot create real debt, and failed to properly focus on the terms of the instrument in determining its characterization. In other words, the Tax Court's analysis of the instrument's provisions was inappropriately subordinated to the consequence of lenders and borrowers relationship. Moreover, there were many interested third parties here who cared about, and were concerned with, the existence of this tranche of debt (notwithstanding its subordination or relatedness). In a brief oral rebuttal (and only after prodding from one of the judges to address the issue), the government attempted to distinguish an affiliated corporate relationship (where genuine debt, the government admitted, may be possible) from this case, in which the related parties are controlled by close members of the same family, who are just too close, with interests too aligned, to find genuine debt (notwithstanding, that familial terms are customarily used to describe the former, e.g., a "parent" and "brother-sister" corporations).

The critical takeaway for our readers is that there is considerable insight for tax practitioners to gain from the dispute over the tax treatment of the subordinated debt in the *Tribune Media* case. Although the success of the tax planning with respect to the senior debt has captured most of the tax community's attention, everyone should be aware of the subordinated debt issue as well. Further, Shop Talk thinks it invaluable to hear the appellate judges oral rejoinders on the legal issues and arguments, so grab some popcorn subordinated with butter and click here: https://media.ca7.uscourts.gov/sound/external/dab.23-1135.23-1135_02_15_2024.mp3

As always, we welcome our readers' comments (which are never of subordinate importance to your editors).

¹ Shop Talk, "The Taxpayer and Amicus Appellate Briefs in *Tribune Media* Throw Tough Pitches at the IRS," 139 JTAX 05 (November 2023); Shop Talk, "What Was the IRS Thinking in Appealing *Tribune Media*?", 139 JTAX 01 (July 2023); Lipton, "*Tribune Media*: A Split Decision for the Chicago Cubs' Leveraged Partnership Transaction," 136 JTAX 02 (February 2022).

² *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476 (1980).

³ Citing *Moline Properties*, 319 U.S. 436 (1943).